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NSC FOR JCARDENAS
HQ SOUTHCOM ALSO FOR POLAD

E.O. 12958: N/A
TAGS: ECON EFIN VE
SUBJECT: MONETARY CONVERSION: READY OR NOT HERE IT COMES

This message is sensitive, but unclassified. Please treat accordingly.

SUMMARY

¶1. (SBU) The BRV is charging ahead with its project to introduce the new "Bolivar Fuerte," or Strong Bolivar currency on January 1, 2008. With a little over four months before the conversion, and only one month before companies must express prices in both old and new currencies, businesses are beginning to worry about the logistical headaches imposed by the conversion. Most contacts agree that the Central Bank is doing its best to smooth out the process, although the Bank has yet to deal with many of their concerns. The speed with which this project has been carried out also raises questions, as most monetary conversions are usually planned out over years rather than months. Given the determination of Finance Minister Cabezas and President Chavez, the conversion will come, ready or not.

THE BENEFITS

¶2. (SBU) The Central Bank (BCV) cites the benefits of simplifying transactions and accounting procedures as a primary reason for the conversion. Bankers admit that their systems are taxed by the amount of zeroes required, and that removing three zeroes will make accounting simpler for large banks as well as small business owners. The BRV also hopes that inflation will be reduced by making price increases more noticeable to the average Venezuelan consumer. However, the most important factor for Chavez is psychological -- smaller denominations will make goods seem "cheaper" and thus give Venezuelans the perception of increased purchasing power. Chavez has frequently waxed philosophic about his memories of a "strong bolivar" and many contacts believe that, at least initially, the bolivar fuerte will make Venezuelans feel richer. However, given the lack of any reforms to fiscal or monetary policy, any temporary effect should soon be offset by continued liquidity creation and high inflation.

THE TIMELINE

¶3. (SBU) The conversion process has already begun with the BCV and various law firms hosting almost weekly seminars and discussions as businesses prepare for the first deadline in the process on October 1. On October 1, all prices have to be expressed in both "old" and "new" bolivars. Then, on January 1, 2008, the new currency will be introduced and all accounts will be converted to the new BsF. Banking sector contacts have confided to econoffs that they are concerned about the rapidity of the process, especially the requirement to change over all of their systems between midnight on December 31 and opening of business on January 2 (January 1 is a holiday in Venezuela). The banking association has asked the government to declare January 2 a banking holiday to ease this process, though even then it is likely that smaller businesses will have problems changing over their systems.

SHOW ME THE MONEY

¶4. (SBU) Both new and old bolivar currency will be valid for a period of six months (this period may be extended at the BCV's discretion). According to a former BCV official, the BRV may barely make its deadline for distributing the bills, but there will not be a sufficient amount of coins in the country until the end of February, at the earliest. This could cause massive confusion as Venezuelans begin to try to pay with BsF and receive Bs in change (so a bill for 5.25 BsF could be paid by a 10 BsF bill and receive 4 BsF and 750 Bs in change). Cash registers are not designed to tally in multiple currencies, and as anyone who has shopped for

groceries in Venezuela knows, the ability of cashiers to handle such problems on their own is questionable, at best.

FREEDOM OF EXPRESSION

¶5. (SBU) The requirement to express prices in both versions of the currency is causing massive headaches for retailers. Most cash registers are incapable of assigning and expressing two different prices simultaneously. The simple problem of fitting the goods and prices on a receipt is difficult given the limited horizontal space per item. Additionally, accounting and banking systems are often not designed for such a system. According to the President of a large Venezuelan bank, technicians will have to visit each and every ATM and credit card reader in the country to reprogram the software.

¶6. (SBU) Venezuelan securities (stocks, bonds, etc.) are expressed in old bolivars. Some government debt, such as the TICC bonds, are fixed to the bolivar/dollar exchange rate and as such may convert seamlessly to the new bolivar fuerte/ dollar rate. For other bonds, however it remains unclear whether the government will have to issue new paper or amend Venezuelan law to attribute new valuations to these bonds. An oversight could make local Venezuelan bonds worthless on January 1. According to the Ministry of Finance there is a little over USD 16 billion (at the official exchange rate) in outstanding government debt in the local economy.

CHECKING AND BALANCES

¶7. (SBU) Bankers are also worried about processing checks. Banks will have to assume that any check written on December 31 is in old bolivars and any check dated January 1 is in new bolivars. The potential for mistakes is high, which could

result in someone writing a check for one thousand times as much as they intended. In addition, the BCV has said that it will only process old checks through the end of January. After January 31, anyone with an old bolivar-denominated check will have to take it to a bank in person to be cashed, increasing transaction costs and bank lines significantly.

DECIMALS, ROUNDERS

¶8. (SBU) The monetary conversion law makes it illegal to raise prices in conjunction with the monetary conversion and the requirement to express prices in both currencies is in part designed to prevent price increases. Most contacts expect inflation to increase in the last four months of the year. Typically inflation increases during this time period as government and consumer spending increase. In addition, it is likely that the government will open the fiscal taps to build support in advance of the proposed December referendum on constitutional changes, further pressuring prices. Given these almost universal expectations and the threat of raising prices during the conversion process, it is likely that businesses will raise prices in August and September, in advance of the October 1 deadline.

¶9. (SBU) Almost all prices will be expressed in two decimals, however gasoline, LPG, utilities, and stock prices can continue to be quoted with more decimal points. The law also instructs firms to round up when the third decimal point is 5 or above and to round down from 4 and below. Unfortunately, the law does not state when this rounding is to take place. The total cost of a basket of goods will depend on how it is rounded--whether each item is individually rounded up/down or whether they are added together and then the total is rounded up or down. This provides additional opportunities for merchants to take advantage of the process to raise prices. Banks are expected to profit from rounding as the fractions of cents will go to them instead of to clients, who will only be paid interest up to two decimal points.

RUMORS, RUMORS, AND MORE RUMORS

¶10. (SBU) Caracas is rife with rumors as to the BRV's "true intentions" for monetary conversion. Some analysts expect the BRV to package a devaluation with the monetary conversion, setting the new bolivar fuerte at 2.5, 3, or even 4.3 to the dollar. Minister Cabezas, however, effusively denied a devaluation would accompany the monetary conversion again on August 18. One former BCV official suspects just the opposite, that the BRV could revalue the bolivar fuerte at 2/dollar (as opposed to 2.15) to prove to the population that the currency is indeed stronger.

¶11. (SBU) There are also rumors that the BRV will take advantage of the conversion to tax or freeze bank accounts, for example by refusing to convert more than a certain amount of old bolivars to bolivars fuerte. A local broker expects cash withdrawals to shoot up in the months leading up to the conversion due to these fears as well as fears that the BRV may attempt to freeze bank accounts if the process hiccups. A process similar to the "corralito" in Argentina in 2001, this rumor supposes that the BRV would prevent Venezuelans from withdrawing more than a certain amount of money from their accounts, or would tax withdrawals above a certain amount, in order to restrict the money supply (read: to reduce inflationary pressures).

¶12. (SBU) The BCV has already begun reducing its printing of old bolivars and the number of bills in circulation seems to be falling, especially for small denominations. The reduction in bills and coins coupled with a spike in the

demand for cash could lead to shortages and spook Venezuelans, leading to government intervention to prevent a run on the banks.

WHAT'S THE RUSH?

¶13. (SBU) A presentation to VenAmCham on the Brazilian monetary conversion experience by a Vice President at Brazil's Liberal Institute, Roberto Fendt, noted (the obvious) that merely changing a currency's name and removing zeroes does not curtail inflation or make a currency stronger. According to his presentation, Brazil changed its currency eight times between 1942 and 1994, and during that time accumulated inflation was over one quadrillion percent (1 with 16 zeroes). According to Fendt, the creation of the Brazilian Real did work because it included many other factors, including: restriction of government expenditures, creation of a new unit of account to reduce indexing, aggressive trade liberalization, and a new foreign exchange rate management policy. The BRV appears uninterested in any of these methods, convinced that merely removing three zeroes will have the desired effect.

¶14. (SBU) A recent PriceWaterhouseCoopers presentation claimed that the software programming required to change currency valuations requires three times as much as work as that required to fix the Y2K bug. The speed of the conversion has been surprising; announced by Chavez in January, the law which was passed via the ley habilitante, or enabling law in March and will go into effect in October. The new currency will be introduced in January. In total, less than a year from start to finish. The BCV reportedly requested three to four years to plan out a monetary conversion, and former BCV director Maza Zavala once estimated it would take five to six years to properly carry the conversion.

¶15. (SBU) While most contacts agree that the conversion is too little too fast, no one seems to know why the BRV is so seized with the idea. Finance Minister Cabezas has promoted removing three zeroes form the currency since as early as 2005 as a means to fight inflation, and Chavez had mentioned the possibility of introducing a new currency previously, however many contacts wonder, why the rush? The more pessimistic/conspiratorial of Post's contacts believe that

the BRV is trying to provoke a crisis that would give it an excuse to nationalize part or all of the banking sector.

COMMENT

¶16. (SBU) The logistical problems currently facing the monetary conversion process are largely surmountable if the BCV and private sector get their acts together and come up with workable solutions. The larger problems of inflation and financial sector instability will not be addressed by the conversion. These problems may, in fact become worse as inflation continues to grow and worried Venezuelans move to cash or hard assets in advance of a conversion many expect to be botched. The rumors circulating are part and parcel of the lack of transparency that is the hallmark of the BRV. While post does put much faith in most of them, it does not discount the propensity for Chavez to surprise the private sector with bad news. Chavez has previously attacked the banking sector for not directing enough lending to his pet areas and for making too much money, though to nationalize the sector would be drastic, and could lead to a financial panic which he seems keen to avoid thus far.

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